

§ 3.7

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acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the ordinary income account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to such portion.

(2) If any portion of a qualified withdrawal for the acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the capital gain account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to—

(i) Five-eighths of such portion, in the case of a corporation (other than an electing small business corporation, as defined in section 1371 of the Code), or

(ii) One-half of such portion, in the case of any other person.

(3) If any portion of a qualified withdrawal to pay the principal of an indebtedness is made out of the ordinary income account or the capital gain account, then the basis of the vessel, barge, or container (or share therein) with respect to which such indebtedness was incurred is reduced in the manner provided by subparagraphs (1) and (2) of this paragraph. If the aggregate amount of such withdrawal from the ordinary income account and capital gain account would cause a basis reduction in excess of the party's basis in such vessel, barge, or container (or share therein), the excess is applied against the basis of other vessels, barges, or containers (or shares therein) owned by the party at the time of withdrawal in the following order: (i) vessels, barges, or containers (or shares therein) which were the subject of qualified withdrawals in the order in which they were acquired, constructed, or reconstructed; (ii) agreement vessels (as defined in section 607(k)(3) of the Act and § 3.11(a)(3)) and barges and containers which are part of the complement of an agreement vessel (or shares therein) which were not the subject of qualified withdrawals, in the order in which such vessels, barges, or containers (or shares therein) were acquired by the party; and (iii) other vessels, barges, and containers (or shares therein), in the order in which they were acquired by the party. Any

amount of a withdrawal remaining after the application of this subparagraph is to be treated as a nonqualified withdrawal. If the indebtedness was incurred to acquire two or more vessels, barges, or containers (or shares therein), then the basis reduction in such vessels, barges, or containers (or shares therein) is to be made pro rata in proportion to the adjusted basis of such vessels, barges, or containers (or shares therein) computed, however, without regard to this section and adjustments under section 1016(a) (2) and (3) of the Code for depreciation or amortization.

(d) *Basis for depreciation.* For purposes of determining the allowance for depreciation under section 167 of the Code in respect of any property which has been acquired, constructed, or reconstructed from qualified withdrawals, the adjusted basis for determining gain on such property is determined after applying paragraph (c) of this section. In the case of reductions in the basis of any property resulting from the application of paragraph (c)(3) of this section, the party may adopt a method of accounting whereby (1) payments shall reduce the basis of the property on the day such payments are actually made, or (2) payments made at any time during the first half of the party's taxable year shall reduce the basis of the property on the first day of the taxable year, and payments made at any time during the second half of the party's taxable year shall reduce the basis of the property on the first day of the succeeding taxable year. For requirements respecting the change of methods of accounting, see § 1.446-1(e)(3) of the Income Tax Regulations of this chapter.

(e) *Ordinary income treatment of gain from disposition of property acquired with qualified withdrawals.* [Reserved]

§ 3.7 Tax treatment of nonqualified withdrawals.

(a) *In general.* Section 607(h) of the Act provides rules for the tax treatment of nonqualified withdrawals, including rules for adjustments to the various accounts of the fund, the inclusion of amounts in income, and the payment of interest with respect to such amounts.

(b) *Nonqualified withdrawals defined.* Except as provided in section 607 of the Act and § 3.8 (relating to certain corporate reorganizations, changes in partnerships, and transfers by reason of death), any withdrawal from a fund which is not a qualified withdrawal shall be treated as a nonqualified withdrawal which is subject to tax in accordance with section 607(h) of the Act and the provisions of this section. Examples of nonqualified withdrawals are amounts remaining in a fund upon termination of the fund, and withdrawals which are treated as nonqualified withdrawals under section 607(f)(2) of the Act and § 3.5(d) (relating to failure by a party to fulfill substantial obligation under agreement) or under the second sentence of section 607(g)(4) of the Act and § 3.6(c)(3) (relating to payments against indebtedness in excess of basis).

(c) *Order of application of nonqualified withdrawals against deposits.* A nonqualified withdrawal from a fund shall be treated as being made: first, out of the ordinary income account; second, out of the capital gain account; and third, out of the capital account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest nonqualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. Nonqualified withdrawals for research, development, and design expenses incident to new and advanced ship design, machinery, and equipment, and any amount treated as a nonqualified withdrawal under the second sentence of section 607(g)(4) of the Act and § 3.6(c)(3), shall be applied against the deposits within a particular account on a last-in-first-out basis. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made. For special rules concerning the withdrawal of contingent deposits of net proceeds from the installment sale of an agreement vessel, see § 3.2(c)(6).

(d) *Inclusion in income.* (1) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the ordinary income account is to be

included in gross income as an item of ordinary income for the taxable year in which the withdrawal is made.

(2) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the capital gain account is to be included in income as an item of long-term capital gain recognized during the taxable year in which the withdrawal is made.

(3) For effect upon a party's taxable income of capital losses remaining in a fund upon the termination of a fund (which, under paragraph (b) of this section, is treated as a nonqualified withdrawal of amounts remaining in the fund), see § 3.4(e).

(e) *Interest.* (1) For the period on or before the last date prescribed by law, including extensions thereof, for filing the party's Federal income tax return for the taxable year during which a nonqualified withdrawal is made, no interest shall be payable under section 6601 of the Code in respect of the tax on any item which is included in gross income under paragraph (d) of this section, and no addition to such tax for such period shall be payable under section 6651 of the Code. In lieu of the interest and additions to tax under such sections, simple interest on the amount of the tax attributable to any item included in gross income under paragraph (d) of this section is to be paid at the rate of interest determined for the year of withdrawal under subparagraph (2) of this paragraph. Such interest is to be charged for the period from the last date prescribed for payment of tax for the taxable year for which such item was deposited in the fund to the last date for payment of tax for the taxable year in which the withdrawal is made. Both dates are to be determined without regard to any extensions of time for payment. Interest determined under this paragraph which is paid within the taxable year shall be allowed as a deduction for such year under section 163 of the Code. However, such interest is to be treated as part of the party's tax for the year of withdrawal for purposes of collection and in determining any interest or additions to tax for the year of withdrawal under section 6601 or 6651, respectively, of the Code.

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(2) For purposes of section 607(h)(3)(C)(ii) of the Act, and for purposes of certain dispositions of vessels constructed, reconstructed, or acquired with qualified withdrawals described in § 3.6(e), the applicable rate of interest for any nonqualified withdrawal—

(i) Made in a taxable year beginning in 1970 and 1971 is 8 percent.

(ii) Made in a taxable year beginning after 1971, the rate for such year as determined and published jointly by the Secretary of the Treasury or his delegate and the Secretary of Commerce. Such rate shall bear a relationship to 8 percent which the Secretaries determine to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1970. The determination of the applicable rate for any such taxable year will be computed by multiplying 8 percent by the ratio which (a) the average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year, bears to (b) the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined shall be computed to the nearest one-hundredth of 1 percent. If such a determination and publication is made, the latest published percentage shall apply for any taxable year beginning in the calendar year with respect to which publication is made.

(3) No interest shall be payable in respect of taxes on amounts referred to in section 607(h)(2) (i) and (ii) of the Act (relating to withdrawals for research and development and payments against indebtedness in excess of basis) or in the case of any nonqualified withdrawal arising from the application of the recapture provision of section 606(5) of the Merchant Marine Act, 1936, as in effect on December 31, 1969.

(f) *Basis and holding period in the case of property purchased by the fund or considered purchased by the fund.* In the case of a nonqualified withdrawal of property other than money which was purchased by the fund (including deposited property considered under § 3.2(g)(1)(ii) as purchased by the fund),

the adjusted basis of the property in the hands of the party is its adjusted basis to the fund on the day of the withdrawal. In determining the period for which the taxpayer has held the property withdrawn in a nonqualified withdrawal, there shall be included only the period beginning with the date on which the withdrawal occurred. For basis and holding period in the case of nonqualified withdrawals of property other than money deposited into the fund, see § 3.2(g)(4).

§ 3.8 Certain corporate reorganizations and changes in partnerships, and certain transfers on death. [Reserved]

§ 3.9 Consolidated returns. [Reserved]

§ 3.10 Transitional rules for existing funds.

(a) *In general.* Section 607(j) of the Act provides that any person who was maintaining a fund or funds under section 607 of the Merchant Marine Act, 1936, prior to its amendment by the Merchant Marine Act of 1970 (for purposes of this part referred to as “old fund”) may continue to maintain such old fund in the same manner as under prior law subject to the limitations contained in section 607(j) of the Act. Thus, a party may not simultaneously maintain such old fund and a new fund established under the Act.

(b) *Extension of agreement to new fund.* If a person enters into an agreement under the Act to establish a new fund, he may agree to the extension of such agreement to some or all of the amounts in the old fund and transfer the amounts in the old fund to which the agreement is to apply from the old fund to the new fund. If an agreement to establish a new fund is extended to amounts from an old fund, each item in the old fund to which such agreement applies shall be considered to be transferred to the appropriate account in the manner provided for in § 3.8(d) in the new fund in a nontaxable transaction which is in accordance with the provisions of the agreement under which such old fund was maintained. For purposes of determining the amount of interest under section 607(h)(3)(C) of the Act and § 3.7(e), the